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In the Supreme Court of the United States

OCTOBER TERM, 1952

No. 637

THE MARINE MIDLAND TRUST COMPANY OF NEW YORK, *Petitioner*

v.

JOHN J. McGIRL, Trustee of Solar Manufacturing Corporation, Debtor, and the SECURITIES AND EXCHANGE COMMISSION

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (R. 10a-20a)[1] is reported at 200 F. 2d 327. The opinion of

[1] References preceded by a letter "R." refer to the document labelled "Appendix to the Petition for Writ of Certiorari . . ."; references preceded by the letter "P R." refer to the document labelled "Appendix to Brief for Appellant . . ."; references preceded by the letter "T R." refer to the document labelled "Appendix to brief of John J. McGirl, Trustee . . ."

the District Court (PR. 66a-69a) is reported at 102 F. Supp. 859.

JURISDICTION

The judgment of the Court of Appeals was entered December 3, 1952 (R. 21a). The petition for a writ of certiorari was filed March 2, 1953. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether in a proceeding under Chapter X of the Bankruptcy Act the reorganization court may take jurisdiction of counterclaims seeking affirmative relief against an indenture trustee for preferential payments received on a loan to the debtor, where the indenture trustee has filed claims in the proceeding for the balance of the loan and for services and expenses as indenture trustee as well as its accounting as indenture trustee.

2. Whether the reorganization trustee may assert to the claims and accounting of the indenture trustee counterclaims seeking (1) an accounting for cash received from sales of the debtor's property which the indenture trustee to its own advantage as a general creditor failed to require the debtor to segregate for the benefit of debenture holders pursuant to the indenture, and (2) recovery of profits received by the indenture trustee from financing the debtor's accounts receivable in

violation of a negative pledge clause in the indenture.

STATUTE INVOLVED

Pertinent provisions of Chapter X of the Bankruptcy Act (11 U.S.C. 501 *et seq.*) are set out in the Appendix, *infra.*

STATEMENT

The order sought to be reviewed affirmed an order of the District Court, which denied petitioner's motion to dismiss counterclaims asserted against it by the debtor's trustee in the pending reorganization proceeding under Chapter X of the Bankruptcy Act, 52 Stat. 883 (1938), as amended, 11 U.S.C. 501 *et seq.*

The petitioner has filed claims for services ($1,378) and expenses ($3,678) as indenture trustee for the debtor's debenture holders (PR. 3a-6a); for the balance due ($354,340) on a loan by petitioner to the debtor represented by a note; and for breach of warranty ($13,985) in connection with petitioner's financing of the debtor's accounts receivable (PR. 7a-11a). Pursuant to an order of the District Court entered without opposition, petitioner has also filed its account with respect to its activities as indenture trustee (PR. 12a-20a).

The trustee's counterclaims, interposed to petitioner's claims and to its account, and also filed as defenses and objections thereto, seek (1) to recover payments ($320,681) received by petitioner on its loan when it knew the debtor was insolvent (PR.

23a, 31a-32a); (2) profits ($7,963) derived from financing the debtor's accounts in violation of a negative pledge clause (PR. 25a, 45a); and (3) an accounting for cash ($450,000) received from the sale of a plant owned by the debtor in Chicago, which cash was not earmarked in accordance with sinking fund provisions (PR. 24a, 32a-34a, 43a-44a). The counterclaims charge petitioner not only with violating provisions against preferential payments contained in the Bankruptcy Act and in applicable state laws and with violating express provisions of the indenture but also with favoring itself as a general creditor contrary to its fiduciary duties to the debenture holders (PR. 32a-35a, 44a-48a).

Petitioner has been an active participant in the proceedings in the District Court. It first appeared both in its capacity as indenture trustee and as an individual creditor (TR. 3a-4a). It resigned as indenture trustee a few weeks thereafter, however, since "it appeared that existing relationships between the Bank and Solar Manufacturing Corporation might be in conflict with obligations of the Bank, as Trustee under the Indenture" (PR. 19a). Its counsel objected to the trustee's plan and vigorously opposed confirmation thereof (TR. 20a-24a).

ARGUMENT

Although the questions presented by the petition are of importance in the administration of Chapter X, they were decided properly below in conformity

with decisions of this Court and without conflict with holdings in other circuits.[2]

1. *Alexander* v. *Hillman*, 296 U.S. 222, held that the filing of a proof of claim in an equity receivership proceeding constituted a general appearance subjecting the claimant to the jurisdiction of the court, which could grant affirmative relief against the claimant on the basis of counterclaims asserted against it. The Court stated (296 U.S. at 241-242):

> Respondents' contention means that, while invoking the court's jurisdiction to establish their right to participate in the distribution, they may deny its power to require them to account for what they misappropriated. In behalf of creditors and stockholders, the receivers reasonably may insist that, before taking aught, respondents may by the receivership court be required to make restitution.

This holding has frequently been held applicable to bankruptcy cases,[3] and in a proceeding under

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[2] On the second question the court below distinguished a holding of the Court of Appeals for the Second Circuit (per Judges Augustus Hand and Chase, with Judge Learned Hand dissenting). *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797. As we advised the court below, the Commission agrees with the conclusion of the dissenting Judge in that case. It also believes that the facts of the instant case bring it within the principles enunciated by the majority. See *infra*, pp. 11-13.

[3] *Florance* v. *Kresge*, 93 F. 2d 784 (C.A. 4); *Chase National Bank of City of New York* v. *Lyford*, 147 F. 2d 273 (C.A. 2); *Duda* v. *Sterling Manufacturing Co.*, 178 F. 2d 428 (C.A. 8);

Chapter X the court is specifically given powers of both a bankruptcy court and a court of equity.[4]

Petitioner contends that *Alexander* v. *Hillman* does not authorize the procedure in the instant case with respect to the counterclaims for the sums it has received on its loan, arguing that it is entitled to a jury trial of the issues involved since an action to recover a preference has traditionally been one at law.[5] The court below properly held, however,

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Columbia Foundry v. *Lochner*, 179 F. 2d 630 (C.A. 4); *In re Nathan*, 98 F. Supp. 686 (S.D. Cal.); *In re Petroleum Conversion Corporation*, 99 F. Supp. 899 (D. Del.). Petitioner complains (p. 17) that the court below did not take cognizance of Sections 60b, 67e, and 70e(3) of the Bankruptcy Act, dealing with the avoidance of fraudulent transfers and preferences, which refer to the institution of plenary suits. None of these sections, however, forbids summary disposition of affirmative counterclaims and each of them actually takes cognizance of occasions when the bankruptcy court does have summary jurisdiction by expressly limiting the application of the subsection to situations "where plenary proceedings are necessary."

[4] Bankruptcy Act, Sections 114 and 115, 11 U.S.C. 514 and 515.

[5] Petitioner also argues (Pet. 19-20) that the recent amendment to Section 2a(7) of the Bankruptcy Act, contained in Public Law 456 of the 82d Congress, abrogates the doctrine of *Alexander* v. *Hillman*. The amendment provides that

> . . . where in a controversy arising in a proceeding under this Act an adverse party does not interpose objection to the summary jurisdiction of the court of bankruptcy, by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or extended by order of court for the filing of an answer

that the reorganization court would have jurisdiction to determine the counterclaims involved, even if they were of a nature ordinarily triable at law, since they were for payments made on the very debt which is the subject of petitioner's claim and the questions raised would necessarily have to be decided in connection with the defense to that claim (R. 16a). This decision is in accord with *Columbia Foundry* v. *Lochner*, 179 F. 2d 630, in which the Court of Appeals for the Fourth Circuit held that a bankruptcy court could determine the counterclaim to a claim filed for the balance due for goods sold and delivered where the counterclaim was based on defects in the merchandise which had been

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to the petition, motion or other pleading to which he is adverse, he shall be deemed to have consented to such jurisdiction; . . .

Apart from the fact that this amendment did not become effective until October 7, 1952, and was not called to the attention of the court below, it should be noted that the sole purpose of the amendment, as explained in the Committee Reports, was to overrule the holding of *Cline* v. *Kaplan*, 323 U. S. 97, "that a respondent has not consented to the summary jurisdiction of the bankruptcy court if he made formal objection at any time before the entry of the final order in the proceeding, even though the controversy had gone forward on its merits without his preliminary objection to jurisdiction." S. Rep. No. 1395, 82d Cong., 2d Sess. (1952), p. 3. See also H. Rep. No. 2320, 82d Cong., 2d Sess. (1952), p. 4. The amendment does not relate in any way to the matter of submission to the bankruptcy court's jurisdiction through filing of a proof of claim or an accounting or through general appearances in the proceeding.

the subject of the sale.[6] See also *In re Nathan,* 98 F. Supp. 686 (S.D. Cal.) referred to by petitioner (Pet. 14-15), which involved, as here, the very question of preferential payment on notes constituting the basis of the claim, and which held squarely contrary to petitioner's contention. These decisions and the decision below are in accordance with the rule set forth in *Alexander* v. *Hillman* that "courts of equity . . . having jurisdiction of the parties to controversies brought before them . . . will decide all matters in dispute and decree complete relief." In the instant case, as in *Alexander* v. *Hillman,* 296 U.S. at 242:

> Distribution may not be made without decision upon the counterclaims. Nothing is more clearly a part of the subject matter of the main suit than recovery of all that to the *res* belongs.

We believe, moreover, that the counterclaims are essentially equitable in nature as in *Alexander* v. *Hillman,* where they were based on money received by the defendants from the debtor in violation of their fiduciary duties as officers and directors.

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[6] A determination whether or not appellant was entitled to the payments it received on its loan is not only related to its claim on the loan, but also to its claim for services as indenture trustee, and to its accounting as an indenture trustee, since an indenture trustee should be denied compensation "if he has been guilty of a breach of trust." See *Dabney* v. *Chase National Bank of City of New York,* 196 F. 2d 668, 673 (C.A. 2), citing Restatement of Trusts, §§ 243, 245.

Here they are based on sums received from the debtor by appellant in violation of its fiduciary duty as indenture trustee. Such a cause of action is one for breach of trust. *Clarke* v. *Chase National Bank of City of New York,* 137 F. 2d 797, 801 (C.A. 2); *Dabney* v. *Chase National Bank of City of New York,* 196 F. 2d 668 (C.A. 2). That the facts involved might be such that appellant would have to return the payments even if it had not occupied a fiduciary position should not give it additional procedural rights. See *Dabney* v. *Chase National Bank,* 196 F. 2d 668, 670, where, in holding an indenture trustee liable for preferring itself over its *cestuis,* the Court, per Judge Learned Hand, pointed out:

> The duty of a creditor to take no more than his aliquot share of the assets of an insolvent debtor is imposed by law; the duty of a trustee, not to profit at the possible expense of his beneficiary, is the most fundamental of the duties which he accepts when he becomes a trustee.

The exercise of summary jurisdiction is fortified in the instant case, since petitioner not only filed its proof of claim in this proceeding but participated actively therein and, as required by the district court, filed an accounting herein (see p. 3, *supra*).

2. The counterclaims seeking recovery of the profits petitioner received from financing the debtor's accounts and seeking an accounting for

the cash from the sale of the debtor's Chicago plant may be adjudicated at the instance of the reorganization trustee. The court below found these causes of action were for the restoration of trust funds and bore "the closest possible relationship" to petitioner's account (R. 18a). Actions for the restoration of trust funds have traditionally been brought by the reorganization trustee. See *Central Hanover Bank & Trust Co.* v. *President and Directors of Manhattan Co.*, 105 F. 2d 130 (C.A. 2); *Brooklyn Trust Co.* v. *Kelby*, 134 F. 2d 105 (C.A. 2), certiorari denied, 319 U.S. 767.

Section 212 of the Act expressly authorizes the Chapter X court to "examine", "disregard any provision of", and "enforce an accounting" under a trust indenture. When viewed in the light of the primary aim of Chapter X to provide effective measures to protect the rights of public investors against those who have violated their fiduciary obligations to them, it becomes clear that the Chapter X court is an appropriate forum for complete settlement of an indenture trustee's accounting, necessarily including any exceptions, objections or counterclaims thereto.

Petitioner argues that the trustee can enforce no action which the debtor itself could not have brought (Pet. 23), although it admits some exceptions where "necessary for the perfection of the plan of reorganization" (Pet. 25). But a bankruptcy trustee's powers are not so limited and a Chapter X trustee, in addition to exercising the

power of a trustee in bankruptcy,[7] may exercise the powers of an equity receiver.[8] This Court has held that an equity receiver may maintain an action for the benefit of creditors to recover profits and restore trust assets irrespective of whether or not the corporation in receivership might itself have maintained the cause of action. *McCandless* v. *Furlaud*, 296 U.S. 140, 160.

Petitioner argues that the causes of action here are similar to those which the majority of the Court of Appeals for the Second Circuit refused to permit the reorganization trustee to enforce in *Clarke* v. *Chase National Bank of City of New York*, 137 F. 2d 797. The court there, while permitting the reorganization trustee to sue on some causes of action against the indenture trustee, held that he could not sue on others which were based solely on the indenture trustee's negligence.[9] Unlike that case, however,

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[7] Section 186 of the Act, 11 U.S.C. 586, provides that a Chapter X trustee is vested with "such title" as a trustee in ordinary bankruptcy would have. As pointed out in 4 Collier on *Bankruptcy*, 14th Ed. (1942), p. 948: "general pronouncements are subject to well-recognized exceptions created by the Bankruptcy Act itself, through which the trustee is given powers to assert claims against property in the hands of others where the bankrupt would be estopped to act and, in some cases, where there are no creditors who could assert such claims."

[8] Section 187, 11 U.S.C. 587, specifically so provides "if authorized by the judge," and it is not disputed that such authorization was given in this case.

[9] It appears that the decision with respect to those causes of action may have been based, in part at least, on a rule

as pointed out by the court below, claims here are asserted as counterclaims to petitioner's accounting and proofs of claims for trustee's fees (R. 18a). Subsequent to the decision below, the Court of Appeals for the Second Circuit, in a case where an indenture trustee had presented its account, permitted a reorganization trustee's successor to press a proposed surcharge against the indenture trustee for its alleged negligence. *Prudence-Bonds Corporation* v. *State Street Trust Company* (March 3, 1953). Moreover, in our view the causes of action herein filed are less similar to those which the court refused to permit the reorganization trustee to enforce in the *Clarke* case than to those which it specifically permitted him to enforce. Those latter were based on the indenture trustee's failure to refrain from competing with its principals, the debenture holders. As to these the court held (137 F. 2d at 801) "that any funds recovered would be so far related to the proposed reorganization as to necessitate their inclusion within the 'extended meaning of the debtor's property,' *Central Hanover B. & T. Co.* v. *President, etc., of M. Co.*, 2 Cir., 105 F. 2d 130, 132, and to authorize the trustee

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peculiar to New York and since changed by statute that a claim for breach of trust against an indenture trustee not involving the impairment of a *res* did not pass to the transferee with the sale of the securities but was retained by the owner of the securities at the time the breach occurred. See Report of the Law Revision Commission (N.Y.) Legislative Document 65(D) (1950); N. Y. Consolidated Laws, Personal Property Law, § 41, sub. 4, added by L. 1950, c. 812.

to reduce the fund to possession and hold it for such disposition as may be found to be proper." This is in accord with *Alexander* v. *Hillman,* 296 U.S. 222, 235-236, where an equity receiver was permitted to recover moneys disbursed and property transferred in violation of fiduciary duties. In the instant case, it is alleged that the commingling by the petitioner of the proceeds of the Chicago sale with debtor's other funds benefitted the petitioner in its capacity as an unsecured creditor and was detrimental to the debenture holders. It was also alleged that the profits which are sought to be recovered from petitioner's financing of the debtor's accounts resulted from petitioner's active violation of a trust indenture provision set up for the protection of the debenture holders.

Petitioner also cites the *Clarke* case in urging that assertion of claims by the Chapter X trustee must be necessary to perfect the plan and argues (Pet. 25) that the court below in this case "did not and could not find that the assertion of . . . [the] claims [here involved] by the trustee was necessary for the perfection of the plan of reorganization, because the so-called plan of reorganization had already been confirmed and almost wholly consummated." Questions with respect to the claims and counterclaims involving the petitioner, however, were specifically reserved in the plan, and the situation here is comparable to that relating to the plan of reorganization of Associated Gas and Electric

Co. involved in the *Clarke* case. When the plan there was prepared, the litigation was still pending and provision was made in the plan for eventualities of recovery and non-recovery. Although the plan has long since been confirmed and consummated, the litigation has been continuing. See *Dabney* v. *Chase National Bank of the City of New York,* 196 F. 2d 668 (C.A. 2), and *Dabney* v. *Chase National Bank of the City of New York,* CCH Bank. L. Serv. Par. 57,762 (Jan. 8, 1953). Cf. *Brown* v. *Gerdes,* 321 U.S. 178, 183.

Petitioner also contends that because the plan in the instant case has taken the form of a plan of liquidation, rules normally applicable to Chapter X should not apply, but petitioner does not dispute that the debtor was properly in Chapter X, nor could it at this late date.[10] Since jurisdiction of the Chapter X court properly attached to the

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[10] Plans of reorganization frequently take the form of liquidation either by sale of assets in the reorganization proceeding (See *e.g., In re Lorraine Castle Apartments Bldg. Corp.,* 149 F. 2d 55 (C.A. 7), certiorari denied, 326 U.S. 728); *Country Life Apartments, Inc.* v. *Buckley,* 145 F. 2d 935 (C.A. 2.).) or through a realization corporation. (See *e.g., Prudence Realization Corp.* v. *Geist,* 316 U.S. 89). Recovery of the trust *res* is essential to the consummation of a fair and equitable plan of reorganization whether recovery is sought of particular assets for use in the business of the reorganized company or of cash for direct distribution to security holders. The fairness of the allocation of the estate in either case is dependent upon such recovery. This is particularly true in this case, where the indenture trustee, against whom recovery is sought, is itself a claimant against the estate.

debtor, its security holders were entitled to all the protections provided for them in Chapter X. Accordingly, the initiation of the instant proceeding constituted the Chapter X court an appropriate forum for the purpose of requiring petitioner to account, since the court is specifically empowered by Section 212 to "enforce an accounting" under a trust indenture.

As stated by the court below, "once jurisdiction attaches it is of minor importance whether the trustee, the substituted indenture trustee or the cestuis raises the question of the alleged breach of trust." (R. 20a)[11] The concern of Congress for all of the security holders of debtors in reorganization indicates that it did not intend artificial procedural barriers to stand in the way of the enforcement of causes of action by the reorganization trustee which would redound to the benefit of any group of the debtor's security holders.[12] If these causes of

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[11] As the court below pointed out, a debenture holders' committee had sought to have petitioner account and debenture holders had objected to petitioner's account as filed (20a).

[12] See, *e.g.*, H. Rep. No. 1409, 75th Cong., 1st Sess. (1937), 43:

> It would be idle to provide that protective measures be adopted without likewise providing the means whereby such protection can be afforded . . . There must be power and responsibility in the hands of a qualified representative of investors. Otherwise disorganization may result. Investors must be afforded a "focal point" for organization. Such a device as the independent trustee furnishes them with one in the cases big enough to possess an appreciable investor interest . . .

action are not brought by the Chapter X trustee, in view of the traditional difficulty for scattered security holders to enforce their common rights, the likelihood of any successful action being brought would seem to be materially lessened.[13] As a practical matter, most actions enforced by the reorganization trustee, even if technically on behalf of the estate, will not redound to the benefit of every security holder of the estate, whether because, as is the case with some senior creditors, they will be paid in full in any event, or, as may be the case with some juniors, they will not be reached in any event. *Cf. Committee for Holders of Central States Electric Corp. 7% Cumulative Preferred Stock* v. *Kent,* 143 F. 2d 684, 687 (C.A. 4). Moreover, enforcement of a cause of action on behalf of one class of security holders may benefit not only that class but, by reducing their claims against the estate, may also benefit other security holders whose claims against the estate are on a par with or junior to those on whose behalf recoveries have been effected.

It should be of no moment to an indenture trustee, once jurisdiction attaches, whether it be the Chapter X trustee, a substituted indenture trustee, or the *cestui* who raises the question of an alleged breach of trust. A Chapter X court could well take notice of a breach of trust by a fiduciary such

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[13] In the instant case, the petitioner itself first came in the case as a representative of debenture holders. After petitioner's resignation, a successor indenture trustee was appointed but has since resigned.

as an indenture trustee, no matter how the matter is brought to its attention. *Dudley* v. *Mealey,* 147 F. 2d 268, 270 (C.A. 2), certiorari denied, 325 U. S. 873.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

ROBERT L. STERN,
Acting Solicitor General.

ROGER S. FOSTER,
General Counsel,
Securities & Exchange Commission.

APRIL, 1953

APPENDIX

There follow the pertinent provisions of the Bankruptcy Act, as amended, 52 Stat. 840, 11 U.S.C. 1 *et seq.*:

SEC. 2. CREATION OF COURTS OF BANKRUPTCY AND THEIR JURISDICTION.—a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

* * * * * * *

(7) Cause the estates of bankrupts to be collected, reduced to money and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested interests of the bankrupt's spouse in the property of any estate, whenever under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest;

SEC. 114. Upon the approval of a petition, the jurisdiction, powers, and duties of the court and of its officers, where not inconsistent with the pro-

visions of this chapter, shall be the same as in a bankruptcy proceeding upon adjudication.

SEC. 115. Upon the approval of a petition, the court shall have and may, in addition to the jurisdiction, powers, and duties hereinabove and elsewhere in this chapter conferred and imposed upon it, exercise all the powers, not inconsistent with the provisions of this chapter, which a court of the United States would have if it had appointed a receiver in equity of the property of the debtor on the ground of insolvency or inability to meet its debts as they mature.

SEC. 186. A trustee, upon his appointment and qualification, shall be vested with such title as a trustee appointed under section 44 of this Act would have.

SEC. 187. Where not inconsistent with the provisions of this chapter, a trustee, upon his appointment and qualification, shall be vested with the same rights, be subject to the same duties, and exercise the same powers as a trustee appointed under section 44 of this Act, and, if authorized by the judge, shall have and may exercise such additional rights and powers as a receiver in equity would have if appointed by a court of the United States for the property of the debtor.

SEC. 212. The judge may examine and disregard any provision of a deposit agreement, proxy, power or warrant of attorney, trust mortgage, trust in-

denture, or deed of trust, or committee or other authorization, by the terms of which an agent, attorney, indenture trustee, or committee purports to represent any creditor or stockholder, may enforce an accounting thereunder, may restrain the exercise of any power which he finds to be unfair or not consistent with public policy and may limit any claim or stock acquired by such person or committee in contemplation or in the course of the proceeding under this chapter to the actual consideration paid therefor.

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